

TAX·FEATURES

Federal Debt Ceiling Hits \$2.3 Trillion; \$10,000 Apiece for All U.S. Residents

Shadow Budget Committee Says Continuing Resolutions Threaten Budget Process

Abuse of continuing resolutions is growing and "reflects a real breakdown of orderly budgeting in Congress and undermines the capacity of both the Legislative and Executive Branches to make responsible spending decisions," according to a recently released report from the Tax Foundation's Shadow Committee on the Federal Budget.

The omnibus spending bill passed October 8, the Committee report asserts, contained "an extraordinary provision" that "could threaten the very basis of constitutional government in the United States," if it became a precedent for more expanded use. The provision in question, which was effective through October 8, would have allowed certain regular appropriation bills to become law "without final passage by Congress and without presidential review," the report charged. "The resolution would allow conferees 'to set spending at any level they wanted, and insert any extraneous legislation, and neither the President nor Congress would have any recourse.' Imagine the mischief that might be done if this type of provision were effective for a full fiscal year!

"Continuing resolutions are not new legislative devices; they were first used more than a century ago (in 1876) when Congress provided interim funding for certain accounts that had not received regular appropriations by the start of the fiscal year. But the evolution of continuing resolutions into massive measures that supplant regular appropriations, provide full-year (not just stopgap) financing for many Federal programs and agencies, and serve as a vehicle for unrelated legislation is a recent development. Consequently, these resolutions have grown dramatically from 1-2 pages in the early 1970s to 363 pages in fiscal 1985 and 142 pages in fiscal 1986.

Appropriations committees use the resolutions to veto-proof bills that contain spending levels at variance with the Administration's. Committees and individual Members load preferential riders on the resolutions that would never make it through the legislative pipeline.

Why does the continuing resolution serve these covert agendas so well? First, continuing resolutions are

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What goes up must come down—unless it's the Federal debt. Uncle Sam's indebtedness, like Topsy, just keeps growing. The latest peak in the Alpine reaches of the alleged Federal debt "ceiling" is \$2,300 trillion. It hove into view last October 18, when Congress ok'd a \$189 billion "temporary" increase before rushing home to face the voters. That action recognizes that every man, woman, and child in the United States will be owing about \$10,000 apiece as their "share" of the national debt in 1987, triple the amount ten years ago.

Only a Temporary Solution

The debt ceiling boost, the 24th in the last 10 years, again is only temporary. Congress must act by next May 15, or the legal ceiling will revert to \$2,111 trillion. Don't bet on that happening. Because of continuing deficits, some time next year, Congress will need to pass another debt ceiling hike, probably well over the \$2.3 trillion mark.

This October's hike in the debt ceiling was the second one this year. In August Congress approved a \$32 billion increase that was needed to pay September 3 Social Security benefits without adversely affecting the Social Security trust funds.

Earlier this year both the House and Senate approved bills that would have raised the ceiling even

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Federal Deficits, Debt Outstanding, and Related Measures

Selected Fiscal Years 1977 - 1987
(Billions, except per capita)

Year	Debt outstanding ^a		Net interest	Deficit	Outlays	Receipts
	Total	Per capita				
1977	\$709.1	\$3,210	\$29.9	\$-53.6	\$409.2	\$355.6
1978	780.4	3,495	35.4	-59.2	458.7	399.6
1979	833.8	3,693	42.6	-40.2	503.5	463.3
1980	914.3	4,002	52.5	-73.8	590.9	517.1
1981	1,003.9	4,349	68.7	-78.9	678.2	599.3
1982	1,147.0	4,919	85.0	-127.9	745.7	617.8
1983	1,381.9	5,869	89.8	-207.8	808.3	600.6
1984	1,576.7	6,634	111.1	-185.3	851.8	666.5
1985	1,827.5	7,617	129.2	-211.9	946.0	734.1
1986	2,129.5	8,792	135.3	-220.7	989.8	769.1
1987	2,354.9 ^b	9,631 ^b	140.9 ^b	-163.4 ^c	990.5 ^c	827.1 ^c

a. End of fiscal period.

b. Office of Management and Budget estimate as of August 6, 1986.

c. Average of estimates by Congressional Budget Office and Office of Management and Budget in Initial Sequestration Report for Fiscal Year 1987, August 20, 1986.

New 1986 State Laws To Boost Taxes In 16 States; Cut Them in 4 States

State legislation in 1986 will boost taxes in 16 states by a total of \$2.4 billion annually and will cut taxes in another six states by \$.8 billion, according to a Tax Foundation survey. The net effect of the statutory changes is to raise the annual level of overall state taxes by \$1.6 billion. That is equivalent to less than one percent of fiscal year 1986 collections, which are estimated at \$227.7 billion, say Tax Foundation researchers.

This was the third straight year in which the net changes enacted were less than one percent of state tax collections.

This year's new state tax laws dealt predominantly with levies on general sales, motor fuels, and personal income. Six states hiked sales tax rates, eight states raised motor fuels rates, five increased cigarette taxes, two increased corporate income taxes, and one state raised personal income tax rates. Six states took action to reduce their personal income taxes.

Altogether, Idaho, Kansas, Nebraska, New Mexico, Virginia, and Texas will pick up an additional \$1.3 billion a year in new revenue from higher sales tax rates. Idaho's rate will rise from 4 percent to 5 percent, for the period April 1, 1986 through June 30, 1987. The Kansas rate goes from 3 percent to 4 percent, beginning July 1, 1986. The Nebraska sales tax rate will rise from 3.5 percent to 4.5 percent on January 1, 1987. New Mexico's rate hike, from 3.75 percent to 4.75 percent, took effect on July 1, 1986. For the period January 1, 1987 through August 31, 1987, the Texas sales tax rate will rise from 4.125 percent to 5.25 percent. Virginia's increase, from 3 percent to 3.5 percent, becomes effective January 1, 1987.

Most of the remaining increase—nearly \$1 billion—will come from motor fuels tax increases in Colorado, Delaware, Kentucky, Montana, North Carolina, Tennessee, Texas, and Virginia. In Colorado the gasoline tax was raised from 12 cents to 18 cents a gallon; Delaware, 11 cents to 13 cents; Kentucky, 10 cents to 15 cents; Montana, 15 cents to 17 cents; North Carolina, 12.25 cents to 14.25 cents; Tennessee, 12 cents to 15 cents; Texas, 10 cents to 15 cents; and Virginia, 11 cents to 17.5 cents.

Cigarette tax increases will add about \$90 million to revenues in Colorado, Florida, New Mexico, Rhode Island,

and Washington. By raising its rate from 23 cents to 31 cents a pack of 20 cigarettes, Washington gained the distinction of having the highest rate in the nation. Other increases were in Colorado, 15 cents to 20 cents a pack; Florida, 21 cents to 24 cents; New Mexico, 12 cents to 15 cents; and Rhode Island, 23.4 cents to 25 cents. In addition, four states—Colorado, Maine, New Mexico, and Washington—levied a new tax on tobacco products that had not been previously taxed.

New Mexico was the only state to raise personal income taxes. Colorado and Maine increased corporate tax rates. In addition to other changes, Maine doubled its excise taxes on beer, wine, and spirits.

Personal income tax cuts in Connecticut, Delaware, Massachusetts, Michigan, Pennsylvania, and Vermont account for nearly all of the 1986 legislative tax reductions. Connecticut lowered its tax on dividends and capital gains, beginning January 1, 1986. Delaware cut its personal income tax rates by 9 percent for tax years after 1986. Massachusetts repealed a 7.5 percent surtax on its tax, retroactive to January 1, 1986. Michigan accelerated a scheduled cut in its income tax to save taxpayers an estimated \$360 million annually, effective April 1, 1986, the flat-rate tax dropped from 5.1 percent to 4.6 percent. Pennsylvania cut its flat-rate tax from 2.2 percent to 2.1 percent, effective September 1, 1986; and Vermont dropped its rate from 26.5 percent of Federal tax liability to 24 percent for tax years beginning after 1986. The Vermont legislature also stipulated that if Federal tax provisions were changed after the legislature adjourned and before the 1987 legislative session began, the state tax rate could be altered to obtain the same revenues as the amount anticipated before the Federal changes.

In addition to lowering its personal income tax rate, Pennsylvania cut its corporate income tax rate, effective in calendar year 1987, from 9.5 percent to 8.5 percent. In other action on corporate income taxes, California, Idaho, New Hampshire, and Utah revised their taxation of multinational corporate income from a worldwide to a water's-edge basis; that is, the states will tax multinational corporations only on their income produced in the United States.

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not covered by the House's rules barring legislation in appropriation bills. Second, as the "last train out of the station," the continuing resolution is often the final chance to move a stalled bill down the tracks. In addition, the stalled item is virtually hidden within the haystack of the resolution's legal verbiage. As a result, the length of continuing resolutions has mushroomed.

Number of Pages in Lengthiest Continuing Resolution

Fiscal Year	Pages
1980	8
1981	9
1982	21
1983	95
1984	19
1985	363
1986	142

What can be done? The Shadow Budget Committee notes that any reform, if it is to succeed, must "take away the advantages of delay" and must not give undue leverage to any side.

"Automatic continuation of programs and agencies which have not received their regular appropriations by the start of the fiscal year at or before the previous year's spending level would provide Congress with a strong incentive to act on the regular appropriations bills."

Finally, to remove the continuing resolution's attractiveness as a vehicle for unrelated legislation, the Committee recommends that such resolutions "be made subject to House and Senate rules barring legislation in appropriation bills."

The report, "The Misuse of Continuing Resolutions," is available from the Tax Foundation for \$4, plus \$1 postage and handling.

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Evolution of a New System

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By Frederic W. Hickman

Most are aware that the pace of tax "reform," so-called, has picked up in recent years. The table on page 6 is a summary of the major revenue bills over the last 40 years, since the end of World War II. During the first half of that period there were a number of revenue acts, occurring at reasonable intervals. But most of them were what you might call economist's acts, that is, they responded to the need to increase or reduce tax revenues and did not involve much reform. The Revenue Act of 1962, the major revenue act of the Kennedy Administration, did institute major changes designed to encourage investment and lift the economy from a relatively stagnant condition. But it did not tinker extensively with the tax machinery.

The real tax reform movement commenced with the Tax Reform Act of 1969. It was enacted in the first year of the Nixon Administration, but it was, in fact, a legacy left from the prior Johnson Administration in the form of a large package of Treasury reform proposals floated just prior to the end of that Administration and attended by extensive publicity about a relatively few high-income individuals who paid little or no tax.

From 1969 to date the Congressional tax-writing committees have been engaged almost without interruption in the consideration of so-called "tax reform" proposals. Tax-writing committees, which used to meet on a far less than regular basis, have been meeting daily, week in and week out.

The Tax Reform Act of 1981, the first revenue act under the Reagan Administration, provided the largest tax cut in history and substantially liberalized many tax provisions. The next three tax acts, the latest of which is the one before us, have been devoted in significant part to reversing the benefits conferred in the Revenue Act of 1981.

Responsible for Accelerating Tax Changes

If we can identify the factors that were responsible for this unrelenting legislative activity, we will perhaps have a clue as to what we can expect in the future.

• *Inflation and the "fiscal dividend."* The first factor accounting for all this activity has been inflation and the so-called "fiscal dividend" that results from inflation. Under a graduated rate tax system, as money incomes rise, tax revenues rise even faster because a larger percentage of the total income is thrown into progressively higher brackets. This

phenomenon is sometimes referred to as "bracket creep." At the same time, real incomes also rise, compounding the effect. The extra revenues that result are sometimes referred to as the "fiscal dividend." Government spending has also risen throughout the period, but during much of the period

Conclusions on the Tax Reform Act of 1986

1. The tax changes enacted are massive in terms of their number and the complexity and mischief they will create. In terms of dealing with fundamentals, the single big change is a dramatic reduction in marginal rates. All the rest is shifting and tinkering. But the shifting and tinkering is, in total, massive, and may have major fallout.

2. There are no revolutionary ideas or concepts involved. The basic approach, which is to broaden the tax base and lower the rates, has been under discussion for 50 years. If you went to the Treasury Department attic and plowed through its old trunks of tax proposals you would find repeated proposals for most of what has been done in this bill.

3. In terms of the Act's long-run effect on the economy, some believe lower, marginal rates will work miracles. Most don't believe that. Many believe that changes, dislocations or disruptions will be major negative influences. In any event, the economy will survive. The biggest changes are simply undoing, either directly or indirectly, events that occurred in the last decade or so. The economy survived and prospered before those changes occurred, and it will survive and prosper after they are undone. In the grand scheme of things the tax changes are a relatively minor influence.

4. In the short run, the impact on the economy is apt to be sharply negative. That is because the hundreds of small changes will disrupt existing procedures and relationships. Companies will have to revamp a great many existing procedures in order to remain competitive. They will do that successfully in most cases. But there is a cost in the dislocations and revamping, not the least of which is unemployment. Time and resources devoted to dislocation and restructuring are time and resources not used to produce goods and services.

5. A great many of the substantive tax changes in the new legislation are simply wrong—wrong, that is, in the context of accurately measuring income.

6. The final product is full, if you will, of new instabilities. We will almost certainly be rewriting the tax laws next year, the year after, and for as many years as the mind's eye can see.

ABOUT THE AUTHOR

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revenues increased even faster than spending. Congress could, therefore, indulge in cutting taxes, an activity it finds only slightly less pleasurable than spending. Tax reform involves selected tax increases and is almost always painful politically, but becomes tolerable if it occurs in the context of general tax reductions. So the first and probably most important factor is that progressively increasing revenues kept the Congress in a tax legislating, tax reduction mode.

• **Changing economic theories.** A second factor had to do with changing economic theories. In the 1940's and 1950's Keynesian economists were preoccupied with concepts of excess saving and inadequate spending. In the 1960's their emphasis began to change to the need for economic growth. The first major manifestation of the change was the Kennedy Revenue Act of 1962. This theme has dominated the thinking since, and has produced a series of proposals designed to encourage growth.

• **Rules proliferation and the "breeder reactor" effect.** A third factor has to do with the fact that, at least in the tax area, technical rules proliferate in a self-generating way. Like the breeder reactor in the nuclear field, one change fuels an even greater number of new changes. As the rules network becomes increasingly complex, there are more cracks between rules simply because there are more rules, and that in turn provokes new rules to stop up the cracks, which in turn generate new cracks.

• **PACs.** A fourth factor has to do with the rise of the PAC. Congressmen used to count on handing out benefits in order to influence voters. As the cost of election campaigns mushroomed and as PACs were unleashed on the world, some members found that it was even more fruitful to keep the pot constantly boiling than to legislate benefits. Ironically, proposing unpopular tax reforms was often as effective in raising contributions as proposing benefits. Some Congressmen have been accused of raising to an art the process of collecting large sums from industries they were simultaneously attacking, a paradox made possible because many companies felt they could not afford to offend the ringmaster in their ring.

• **The declining share of corporate section revenues: The Reagan revolution and counter-revolution.** A fifth factor was that the share of revenues that came from the corporate sector was declining. Much of that decline had to do with the fact that the corporate sector was itself declining as a percentage of the whole economy and that corporate profits were, furthermore, being squeezed. This was particularly true during periods of high inflation. The trend was greatly accelerated by the first Reagan Revenue Act in 1981, which escalated depreciation deductions far beyond any realistic concepts of economic depreciation. The result was to reduce still further the declining share of revenues represented by the corporate sector. The Revenue Acts of 1982, 1984 and 1986 have been chipping away at what the 1981 Act did. You can think of the last six years, if you will, as a Reagan revolution followed by three counter-revolutions.

• **Voter appeal (?).** Finally, the reform movement has been fueled by the persistent belief that it has voter appeal. It clearly does for some Congressmen and some constituencies. It seems doubtful, however, that it has broad appeal, although in recent years each new administration appears to have started out believing that it does.

The Future Outlook

What does the future hold?

You will note that several of the factors responsible for the reform movement in the past continue today. Academic economists are still focused on growth, rules proliferation and the breeder reactor effect continue exponentially, as the present revenue act attests, and PACs are alive and well. On the other hand, the decline in the share of revenues from the corporate sector has been reversed, but the share is still less than it once was. Whether tax reform will be thought to have political appeal after the current Act remains to be seen.

Bracket indexing and the budget deficit: A whole new world

The one enormous change has been a change in the most important of the factors responsible for past change, namely, inflation and the fiscal dividend. Inflation has not, of course, disappeared; it just seems to have disappeared in comparison with the stratospheric levels attained in the 1970's. What has changed, however, is the bracket indexing adopted in the 1981 Act. Curiously, this was not a Reagan proposal. It was inserted by the Congress and was for a number of months an unloved child, though subsequently it was warmly adopted and stoutly defended. It has radically changed the picture. Real growth in incomes still pushes taxable income into progressively higher brackets, but inflationary increases in money incomes alone no longer do so.

In any event, Congress no longer has the fiscal dividend to play with, and if it is true, as conventional wisdom holds, that tax reform is possible only in the context of tax reduction, the future holds no revenues to fund reduction, and reform activity is likely to be much dampened. It is true that, in this particular bill, we did have tax reform while professing to have revenue tax neutrality rather than tax reduction. But in fact, we had tax reduction for voters by having tax increases for corporations. But there is a limit to the amount by which corporate revenues can be ratcheted upwards, and it seems doubtful that this tactic will work again.

Instability in the new law

Notwithstanding that there are no automatic revenues on the horizon with which to fund reductions, the new law seems inherently unstable politically. The 1981 Act was predictably unstable politically because it gave so much to corporations, leaving them ostensibly subject to an income tax but with a minimal tax burden.

The 1986 Act has a similar defect, probably. Virtually no one alive today can remember top marginal rates as low as 28% for individuals and 34% for corporations. You can predict as well as I whether maximum rates that low have a reasonable chance of surviving in a populist climate in which most voters were taught "at their mother's knee" that the key to tax justice is "ability to pay."

A second instability relates to the issue of capital gains. Capital gains are now taxed at the same rates as ordinary income, a fact which many voters regard as contrary to natural law, although capital gains have been taxed in the past at higher absolute rates than under the new law. If marginal rates are in fact raised in the future, the feelings of injustice will become acute and the treatment of capital gains as ordinary income is likely to unravel, pulling with it other related provisions.

An even more serious instability is the existence of a budget deficit generally viewed as unacceptably large—which

creates pressure for tax change—and the fact that the present bill is likely to increase the deficit still further. The present bill is said to be revenue neutral over the next five years, that is, the revenue gains caused by the bill will about cancel out the revenue losses. Arrayed in tables, the official revenue estimates look authoritative, just as computer printouts look authoritative. But they are estimates, in most cases estimates of the shakiest sort. They are like sausages. If everyone saw how they were made, no one would swallow them. My own judgment is that the estimates probably substantially overstate the revenue gain, particularly in the out years. In fact, we will never know, because it is impossible even in retrospect to measure the revenues we would have had if we had not done what we did. But if it is true that there is an overestimate of revenue gain, the deficit problem will become even more frightening and the pressure for revenue increases of some kind even more compelling.

A final instability arises from the sheer multiplicity of the changes. A bill so large, with so many details, is bound to have a large number of technical glitches and even if technically correct, to cause a large number of economic dislocations in particular companies and industries. There will inevitably be considerable turmoil as these things are ironed out over several years and a continuing demand for corrective legislation.

Special Aspects of this Round of "Reform"

I would like to comment next on three special broad aspects of this round of reform.

First is the question, where does tax reform fit in the Administration's overall strategy in the budget battle?

It is clear, however, that shrinking the relative size of the government sector in the total economy has been a central theme of this Administration. A substantial school of political thought, led most prominently by Milton Friedman, holds that the greatest hope presently available for holding down the government sector is to starve it of revenues. Friedman is perhaps the most eloquent spokesman for the view that the Congress will spend whatever is available and a little bit more, and that the deficit will remain about the same—namely, at the highest level politically tolerable—no matter what revenues are collected. Not everyone believes that theory, but we are clearly giving it a good test.

Whether intentional or not, the current tax reform exercise, with its insistence on revenue neutrality, has implemented this approach. The revenue neutrality requirement was recognized early by the reformers as a political prerequisite to obtaining reform. The political pain of reform was tolerable to the tax writers only if it could be seen as directly funding tax reduction. And you will remember that even that did not work very well, and the whole effort nearly collapsed until the Senate made the rate reductions so dramatic that they overwhelmed opposition to the reform aspects. Reform for the sake of reform or for the abstract aim of narrowing the deficit was a political nonstarter. Thus, those who were committed to tax reform came early to view revenue neutrality as the engine that would produce it.

So long as reform was the order of the day in Congress it forestalled an increase in taxes generally. While there was a small vocal group that sought to add tax increases to the reform package, the more general congressional reaction was that any attempt to increase taxes would invoke White House opposition, undercut the pressure for reform and cause the whole reform effort to unravel.

Thus, history may well view the tax bill as a brilliant and successful strategy to co-opt the liberal reform elements, to prevent an increase in the tax burden and to starve successfully the growth of the government sector. Whether that result was intentional or accidental may never be truly discovered.

Whatever has happened to progressivity?

Traditionally, liberal tax reformers have sought to close loopholes and broaden the tax base in order to make the tax more progressive. This time around the liberal tax reformers jumped into bed with conservative reformers, whose primary aim was to make the rates less progressive. Does the bill increase progressivity or does it not? Which group out-foxed the other?

The first thing to note is that one can't accurately answer the progressivity question by looking solely at the individual income tax. The overall bill is officially estimated to be revenue neutral. But neutrality is the result of an estimated reduction of \$120 billion in the individual income tax accompanied by a like increase in the corporate income tax. While corporations send in tax checks to the IRS, it is, ultimately, individuals who bear the burden of that tax. No attempt was made in the official figures to estimate the distribution of that burden among the individuals who ultimately bear it. That is in part because there is no agreement among economists as to which persons do bear the burden of the corporate tax. That is one of the chief criticisms leveled at the tax, that it is not clear on whom it really falls. The dominant view in recent years seems to be that it falls generally on the owners of capital (as distinguished from the shareholders of a particular corporation or the shareholders of corporations generally) in the form of lower gross returns on capital investments. The owners of capital tend to fall in the upper-income brackets, and if the burden of the corporate tax falls on them, then the corporate increases will operate as invisible offsets to the visible reductions in individual tax for these upper-bracket individuals.

Clearly, there are net reductions in tax for lower-bracket taxpayers which, though small on a per capita basis, are large in aggregate. If it is correct that the bill is neutral overall and that lower-bracket individuals clearly have substantial reduction in their individual income tax and do not bear a significant portion of the corporate tax burden, then upper-bracket taxpayers must have a net increase in tax burden. In that sense—and to that extent—the effect of the bill can be said to be progressive, i.e., lower-bracket taxpayers will pay less tax and upper-bracket taxpayers will bear a larger tax burden (some of which will not be reflected in the individual income taxes they pay).

At the same time, however, the end result will be a rate system that is less steeply progressive than present law. The increases will be very substantial for many high-bracket taxpayers who have been deeply sheltered and are currently paying at low effective tax rates. But there will be dramatic—and visible—reductions for perhaps an even larger group of high-income taxpayers whose real rates correspond closely to statutory rates, for their top marginal rates will drop from 50% to 28%. They are the only taxpayers who will have really significant dollar reductions in their direct tax liabilities.

But even that is not the whole story, for the revenue estimates may not be reliable, or at a minimum, need to be interpreted with care. The shift from individual tax to corporate tax may not be as indicated.

There is, I think, pretty much agreement among economists at both ends of the political spectrum that it is the *marginal* tax rates which have the greatest effect on taxpayer behavior and economic efficiency. Lower marginal rates would enhance efficiency. But most members of the tax reform wing have believed that efficiency aim to be subordinate to the need for progressivity, which they have regarded as a keystone of political fairness.

Eliminating the capital gains preference has been touted by the reform group as perhaps the greatest achievement of the new Act. But, ironically, it has been achieved, not by making the rates more progressive, but by bringing the rates on regular income down to what used to be capital gains rates.

Eliminating the capital gains preference was important in the effort to make the changes in individual taxes appear nonregressive in the upper brackets. There is widespread suspicion among trained observers that the revenue pickups from capital gains were over-generously estimated in order to make the income distribution tables appear nonregressive. If these estimates are in fact too high, the net dollar benefit to higher-income taxpayers is greater than publicly indicated (because the revenue pick-up in those brackets is underestimated).

In addition, the income distribution tables fail to take into account the fact that an increase in the tax liability of a taxpayer who is an investor may not be a *net* detriment because, as the tax increases, there is often an offsetting benefit. This effect can be seen most easily in the case of an investor in municipal bonds. Suppose that the interest rate spread between municipal bonds and taxable bonds is 30%, which it roughly was for many years, so that if a taxable bond produces \$10 of interest income, a comparable municipal bond produces \$7 of interest income. If a 50% taxpayer owns a municipal bond, he gets to keep the full \$7 but if he owns a taxable bond, he gets to keep only \$5. The municipal bond is said in economists' terms to carry an "implicit tax" of 30%, that is, its \$7 yield is 30% less than the \$10 before-tax yield on the taxable bond. If the tax rules are changed so that holding a municipal bond becomes uneconomic and the taxpayer switches to the \$10 taxable bond, the income distribution tables will show him as paying \$5 additional tax. However, he is in fact only \$2 worse off because there was an implicit 30% tax on the municipal bond.

There is a lot of that kind of effect in the current tax bill. The provisions for disallowing passive losses and the minimum tax are examples. They are shown as producing very large revenue pickups from high-income taxpayers, and it is true that those taxpayers will change their behavior and pay more direct tax, but it is also true that the net additional burden that will be imposed on them will be substantially less than the additional tax they remit because they will be simultaneously relieved of an implicit tax they are now paying.

The net result of all this is that, looking at the individual income tax *only*, progressivity has probably been very substantially reduced, and the real reductions for high-bracket taxpayers may be considerably greater than officially indicated. When the corporate changes are also considered, the picture shifts and the Act appears to be progressive in effect. But it is only the individual income tax that the layman focuses on, and if big and highly visible reductions there turn up in the upper brackets, that will, I suggest, be a further instability.

Simplification

Simplification was a much advertised goal in the current round of tax reform. There is not much talk about simplification at this point, but some did occur.

An estimated 6 million taxpayers were deleted from the tax rolls by increasing the personal exemption. More accurately, they were deleted *again* from the tax rolls. This deletion happens every time there is a new round of tax legislation. In the interim since the last legislation, rising real incomes, especially when combined with inflation, push taxpayers deleted from the tax rolls the last time around back into the lower brackets. It is part of the political ritual in every tax bill to delete them again. That is undeniably simplification of a sort, but it is not any kind of major breakthrough.

One real simplifying change concerns the deductions for state and local sales taxes and the so-called "miscellaneous" deductions. To compute those deductions correctly, the taxpayer had to keep a whole shoebox of receipts and records for small daily expenditures. The sales tax deduction has been completely eliminated and the miscellaneous deduction had been practically eliminated for most taxpayers by making it deductible only to the extent it exceeds 2% of the taxpayer's adjusted gross income. This change is probably the most meaningful simplification for ordinary taxpayers.

Of course, the hard, sad fact is that a great proportion of ordinary taxpayers are terrified of anything that involves arithmetic, no matter how simple we make it for them. Those taxpayers are going to go to H. & R. Block, no matter how simple the law becomes.

Much has been made of the fact that the tax rates are lower and that there are only three rate brackets. That is a good thing, but it is not meaningful simplification. It is symbolism that played well in the newspapers, but it is largely without substance. The fact that there are a number of rate brackets under existing law does not complicate anything because the taxpayer does not use all of those brackets. After he has computed his taxable income, he goes to the tables in the instruction form and uses only the top bracket in which his income number falls or simply gets the number directly from a table without any reference to rate brackets.

Ruling Symbolisms

There were two overriding ideas, symbolisms if you will, that dictated the specifics of much of what was done in the bill.

Low Effective Rates

The first had to do with the fact that a number of taxpayers with substantial incomes paid relatively low taxes—taxes substantially lower than would be indicated by the rate tables. This has been widely publicized for the last 15 years in the case of corporations, and everyone knows or thinks he knows a dentist or a doctor who purports to shelter his income.

In tax terminology, we refer to this phenomenon as "low effective rates" of tax. Low effective rates have been commonly misperceived as a fairness issue. In fact, this condition is not a significant fairness issue, but rather a resource allocation issue. Taxpayers who shelter their income with legitimate deductions and credits from investment activities generally find that the tax reduction has been at the expense of a lesser gross yield, just as the owner of municipal bonds pays no tax, but accepts a lesser yield than he would get on

taxable securities. In the case of municipal bonds, there is still a little gravy there for the high-bracket taxpayer, but that appears to be less true in the case of more speculative investments and largely untrue in the case of corporations. Many of the corporations that have the greatest shelter are among the least profitable. Nonetheless, after 15 years of drum beating on this effective rate issue, Congress—and the staff—was determined to stamp out this appearance problem. It was unwilling, however, to eliminate the fundamental causes and enacted a complex set of appearance provisions which do not eliminate “tax shelter” but simply cause less of it to meet the eye.

Uneconomic Investments

One of the comments I hear constantly is that the old tax law caused many uneconomic investments to be made, that it encouraged people to do things for tax reasons alone, and that the new law will surely stop all that.

There is a kernel of truth in that thought, but it is a much smaller kernel than most people realize.

In many cases our tax system seems to *give back* taxes with respect to new investments. In the case of so-called tax shelters, it sometimes appeared that some investors got nothing but tax reductions or refunds. But that did not mean that the projects as a whole were uneconomic.

The appearance problem arises really from two phenomena. The first is that we have used generous depreciation rules and the investment tax credit, as well as the capital gains preference, as relatively simple and rough devices to offset the overstatement of income that is caused by an accounting system that fails to take account of inflation. You are all familiar with the fact that if you buy a house today for \$100,000 and there is 100% inflation and then you sell the house for \$200,000, you are really no better off. However, the tax system overstates your gain. It gives you \$100,000 of taxable income. The same phenomenon occurs in connection with business investments. If you buy a new machine that lasts for a number of years, you are in effect selling it in pieces year-by-year as you use it up in the production of the objects that are sold. In the absence of indexing, the tax accounting system mismeasures income in an inflationary period by counting as income amounts that are not really income.

The greatly accelerated depreciation rules and the investment tax credits are rough offsets to that process. They provide in most cases a tax benefit at the front end of an investment—a reduction or refund in tax—which offsets the tax which is paid at the back end of the investment. In recent years they have probably overdone it somewhat, and it is arguable that at lower rates of inflation, present rules in effect give back as much—or more—tax at the front end as they collect at the back end. But the basic point is that the front end tax benefits must be viewed as part of a transaction occurring over longer periods of time and when so viewed are only offsets to what would otherwise be excessive taxes.

Secondly, it is simply not meaningful—or at any rate it is misleading—to speak of tax rules as causing people to make investments that are “uneconomic.” One cannot determine what is or isn’t “economic” without regard to taxes—they are a part of the cost of any project. It is arguable that in selected cases the tax rules may produce the equivalent of a “negative tax,” i.e., that they produce net income rather than net cost. But those are special cases and they cannot be identified by looking at only a single investor in a project.

There are a great many cases where the items of income and cost, including taxes, are allocated among investors in a project in such a way that some of the investors would not have a profit but for the tax attributes allocated to them. The casual observer often concludes from that fact that the project is “uneconomic.” But that is seldom the case. The existence of such an investor reflects only the method of financing the project, and in order to tell whether the project itself is economic, it is necessary to aggregate the cost and income flows of all the investors in the project.

The Big Changes in Structure

There are three big structural changes of particular importance to business.

Complexity in distinctions among classes of income and deduction

First the new law will produce an almost incredible array of distinctions among kinds of income and deductions and the entities in which they occur, which are dictated by the new rules with respect to passive investment, the new alternative minimum tax provisions and the restrictions on interest.

All of these were motivated by the desire to deal with the appearance problem of low effective rates. The result is *overwhelming* complexity.

That will discourage entrepreneurial investments by individuals. In order to avoid tax penalties the investor must engage in a very sophisticated program of mixing and matching with each other different kinds of investments and entities. In the kinds of investment affected, the complexity will be overwhelming. It will be *too much* for most individual investors. It will simply take them out of this particular segment of the capital marketplace. As a result, it will deprive many enterprises of access to their traditional funding sources. Investment activities affected will be driven out of the hands of individuals and into the hands of corporations or of middlemen entities that are staffed with people and equipped with computers adequately to handle the complexities.

At the corporate level the same kinds of problems will be presented. Activities must be carried on in the proper mix within each corporate entity, in order to avoid stiff tax penalties. Most corporations can gear up to deal with this kind of problem, but it will be complicated and expensive. The new rules will lead to a great variety of acquisitions, combinations, dispositions and other restructuring in order to end up with the proper mix and to maintain the proper mix as conditions change from year to year.

Inversion of the top corporate/individual rates

A second major structural change is the inversion of the top corporate rate and the top individual rate. This is the first time in history that the top corporate rate will be higher than the top individual rate.

The first and most obvious result of this change is that it will make the corporate double tax much more oppressive. The double tax occurs because income is taxed twice, once at the corporate level and again when distributed to stockholders. Under present law the corporate rate is lower than the individual stockholder rate. For many years it was much lower. So long as income was not distributed it was clearly cheaper to be in corporate form. The second tax at the stock-

holder level was often never paid because the profits were never distributed to or realized by the shareholder; or was deferred for long periods of time because there was a long delay between the time profits were taxed at the corporate level and the time they were distributed; or was levied ultimately at capital gains rates, because the shareholder cashed out his investment by selling the stock. As a result, under present law, the economic burden of the second tax has been greatly diminished if not entirely avoided and the so-called double tax has in fact often been less expensive than if the corporate income had been originally taxed directly to the shareholders at higher rates.

Under the new law this will no longer be the case. The initial first level tax at the corporate level will exceed the individual shareholder tax, right from the beginning. When the second tax occurs at the shareholder level, it will further compound that excess.

The result of this shift is that corporate debt will become relatively more desirable even than it has been. That is because when investment in corporations is made in the form of debt, the gross income from that investment will be channeled immediately and directly through the corporate entity to the individual investor. That not only removes the double tax—as it did under prior law—but it causes the income to be taxed directly to distributees whose 28% or less average marginal rate is much lower than the 34% corporate rate.

That same rate inversion will change the basic economics of deferred compensation. Under present law, \$100 of deferred compensation costs the corporation \$46 initially, because it cannot be deducted currently. But it saves the recipient perhaps \$50 currently, so that vis-a-vis the government the parties are at least \$4 ahead. Under the new law, failure to pay the compensation currently will cost the corporation \$34, but will only save the individual \$28, so that vis-a-vis the government the parties are \$6 behind. You can expect to see a lot of creative activity designed to change compensation plans in a way that permits the parties to pick up that \$6 from the government.

Another consequence of the inversion of the rate structure is that it will create major incentives to restructure corporate activities into some kind of conduit entity, such as a partnership, trust or S corporation, which will permit the income to flow directly to the individual investors. The royalty trust was such a device under the old law; incentives for such devices will be much greater under the new law. That kind of restructuring will be viewed with alarm by many as a new loophole, and you can expect to see legislative attention and new sets of rules designed to limit it. In fact, the Ways and Means Committee has already announced that it intends to study the subject of so-called conduit entities.

Shift to Business

A third major structural change comes from the major shift of the tax burden to business. \$120 billion over 5 years in extra corporate taxes is the official estimate. In addition, the increased tax on capital gains is essentially a tax on business. I have already explained that in our tax accounting system inflation causes business income and capital gain to be overstated and, thus, overtaxed, and that the depreciation rules, investment credit and capital gains exclusion have operated roughly to mitigate that fact. But it is the removal of those very items that accounts for much of the increase in business taxes. The new bill is eliminating some of the important fuse breakers that have helped keep inflation from overloading the circuits. While inflation is down from the level of a few

years ago, it is still high by historical standards and high enough to create major distortions in the case of assets held for a significant number of years.

Major Income Tax Legislation Since World War II

Revenue Act of 1948	Tax reduction from wartime levels.
Revenue Act of 1950	Korean War: restored wartime rates, tightened rules for life insurance and exempt organizations.
Excess Profits Tax Act of 1950	Korean War.
Revenue Act of 1951	Further rate increases, numerous special provisions.
Internal Revenue Code of 1954	Extensive rewriting of Code, retaining basic structure but adding many new provisions; slight revenue reduction.
Revenue Act of 1962	Emphasis on investment; enactment of Investment Tax Credit; modest revenue reduction.
Revenue Act of 1964	Major tax reduction and base broadening proposed; major tax reduction adopted, primarily in individual rates; tax base eroded.
Tax Adjustment Act of 1966	Graduated withholding, changes in payments. No changes in liabilities.
Revenue and Expenditure Control Act of 1968	Surtax, major revenue to lessen large deficits; no reform.
Tax Reform Act of 1969	Major "reforms," modest revenue loss; reform items account for more changes than rate reductions; ITC repealed.
Revenue Act of 1971	Tax reduction to respond to economic conditions; ITC reinstated; DISC, depreciation liberalized.
Employee Retirement Income Security Act of 1974 (ERISA)	Extensive changes in pension provisions; IRA's enacted.
Tax Reduction Act of 1975	Major tax reduction responding to recession & inflation; ITC increased; depletion allowances curtailed.
Tax Reform Act of 1976	Numerous "reform" revisions, responding to "reform" proposals under consideration since 1973; focus on tax shelters; little net revenue changes other than from extensions of expiring reductions.
Tax Reduction and Simplification Act of 1977	Major reductions; wide variety of new jobs credit, "tailoring" of incentives, not much "reform."
Revenue Act of 1978	Major tax reductions; many changes both increasing and reducing tax, emphasis on capital formation; rejected major base broadening reforms advanced by Carter Administration.
Crude Oil Windfall Profit Tax Act of 1980	Major revenue gain predicted; repealed carryover of basis at death.
Economic Recovery Tax Act of 1981	Largest tax cut in history for both individuals and corporations. Major increases in depreciation allowance; IRA's extended to everyone; bracket indexing; reduction of top rate to 50%.
Tax Equity and Fiscal Responsibility Act of 1982	Reversed part of 1981 reductions, numerous substantive revisions; significant revenue gain.
Deficit Reduction Act of 1984	Substantial revenue raiser; many substantive changes; further reduction in depreciation allowances; emphasis on time value of money.

(FEDERAL DEFICIT, from page 1)

more—to \$2.323 trillion—to pay the government's obligations through September 30, 1987. But the Senate hung more than two dozen extraneous amendments on its bill, including a controversial plan to restore the automatic budget-cutting provisions of the Gramm-Rudman-Hollings law, struck down in July by the Supreme Court. Consequently, the measure died.

1987 Deficit Level Uncertain

No one knows exactly how much the 1987 deficit will total or how high the legal debt ceiling will have to be to cover next year's borrowings. Fiscal year 1986, which ended September 30, was a big year for red ink. Washington recorded the largest deficit ever—\$220.7 billion—and the largest interest bill ever run up by the U.S. government—\$135.3 billion. As of August 20, the Office of Management and Budget (OMB) estimated the 1987 deficit at \$156.2 billion, while the Congressional Budget Office (CBO) placed it at \$170.6 billion.

Why does the debt ceiling continue to soar higher than the American eagle? Presumably people want—or their elected officials believe they want—government benefits now, leaving to future generations of taxpayers the burden of paying the bills.

Certainly, over the last decade, the upward motion has been unrelenting. Gross debt of the U.S. government passed \$500 billion in 1975. By 1982, it had doubled, topping the \$1 trillion level for the first time. In just four more years, it doubled again, passing \$2 trillion in 1986.

The black hole of debt grows ever faster as interest charges on existing debt increase and the principal remains unpaid. More and more new debt is required just to pay the interest charges on old debt. The process takes on the appearance of a galactic implosion.

Interest Costs Also Soar

Net interest payments rose from \$29.9 billion in 1977 to \$138.9 billion in 1986, and now equal more than 60 percent of the annual deficit and about 40 percent of yearly individual income tax collections.

Interest costs in 1987 are estimated at \$140.9 billion. They will consume 15.3 percent of total budget outlays, up from 8.9 percent at the start of the decade.

Since 1980, interest has been the fastest growing segment of the Federal budget. Net interest payments have

(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation

"Writing Tax Laws with Newspeak"

George Orwell would be delighted. The U.S. Congress is slipping more and more into the Orwellian mode, of turning language upside down so no one, except a self-perpetuating elite can know what really is going on.

Orwell's disturbing vision was presented in his novel, "1984," a fictional account of life in a police state carried to its ultimate absurdity, where thought itself was to be controlled. Language, the handmaiden of thought, thus had to be also subverted to serve the state. The masters' method: reverse the meaning of words, as in "War is Peace."

The U.S. Congress is a long way from that, but it's headed in that direction. The "transition rules" of the 1986 Tax Reform Act, and the way they were inserted in what started out to be a "simpler" tax code, offer the latest case of newspeak in national legislation.

Chaotic procedures and impenetrable language are becoming a congressional trademark. Tax transition rules started out, years ago, as temporary exemptions from new law to prevent unjust or unwise hits on certain individuals or groups. In 1986, hundreds of transition rules became the bargaining chips in deals negotiated privately by a few congressional leaders and their staffers.

The result was page after page of statutory language so convoluted that even

the authors could not understand it. Ludicrous errors—a rule intended for Pensacola, Fla., reportedly benefitted New Orleans, instead—and typographical glitches marred the final version. So an immediate "technical corrections" bill was thrown together, but it became festooned with still more transition rules.

In yet another contretemps, language voted in a budget reconciliation measure contradicted Tax Reform Act language on an understatement of tax penalty. President Reagan signed the budget act first, which meant that it was overruled by the later law, the Tax Reform Act. "Not to worry," said the Treasury Department, in effect, "we will have IRS issue a statement effectively switching the order in which the laws were signed for purposes of this provision. We'll straighten it out in 1987."

With newspeak, anything is possible. That's why the approach is spilling over into all kinds of other legislation and Federal agency regulations. Newspeak is addictive because it greases the way for slipping a controversial idea past opponents since no one—except a few insiders—knows the real meaning of the words used.

Let's bring tax and other laws back to the people. KILL NEWSPEAK! Before it strangles us.



TAX FOUNDATION

(FEDERAL DEFICIT, from page 3)

shot up at an average annual rate of 18.0 percent. (Net interest represents interest paid by the government less interest received on debt held by Federal agencies and accounts.) In comparison, noninterest outlays have risen by less than 7.4 percent a year and receipts at slightly over 7.0 percent annually. The debt itself has grown at a 15.2 percent annual rate.

Increases in the statutory debt limit are typically larger than the expected deficit in a given year, because the debt ceiling also allows for increases in debt sold to trust funds whose surpluses must (by law) be invested in public debt securities.

A History of Upward Growth

The legal debt ceiling has a history of relentlessness in its upward climb. From 1947 through February 1958 the statutory debt limit remained at \$275 billion. But since then Congress has raised the limit nearly every year.

In 1971 Congress enacted a new permanent limit at \$400 billion. All increases from then until 1983 were supposedly temporary increases for limited time periods, as were most increases leading up to 1971.

In 1983, Congress partially faced up to reality and raised the permanent limit to \$1,389.0 billion, the sum of the \$400 billion permanent limit then in effect plus the temporary limit of \$989.0 billion. It eliminated the distinction between the permanent and temporary limits for a while. But now we are headed back on the same old double-speak track of "temporary" increases.

The table on page 1 provides further details on Federal deficits for selected fiscal years 1977-1987.

TF Program for 1986 Will Track Impact Of '86 Tax Act and G-R-H Budget Checks

Efforts to duck or water down the constraints of the Gramm-Rudman-Hollings deficit reduction measure will keep Tax Foundation analysts busy throughout the coming year. The Foundation's "Program for 1987," recently approved for implementation by the Board of Trustees, takes aim at spending levels and the overall budget process, characterizing "truth in budgeting" as a "scarce commodity" in 1986.

"Large Federal deficits in 1987," the program charges, "will unmask last year's 'deficit reduction' activity as little more than 'blue smoke and mirrors.' Congress will be forced to comply with the Gramm-Rudman-Hollings target, or junk the whole process."

Shadow Budget Committee

A primary actor in this budget-watching will be the Shadow Committee on the Federal Budget, a citizen's oversight group established by the Foundation's Trustees in December 1985. The Shadow Budget Committee will continue during the coming year to analyze the evolution of the budget process, starting with the President's Budget for Fiscal 1988, due for release in January.

Committee members will continue to meet with top Administration, Congressional and media officials in an effort to keep budgetary policy on track. They will also begin laying the foundations of a major public conference on the budget process, designed to "bring together public officials, educators, corporate executives and media

representatives from the highest levels of government, business and the private sector."

Taxes Bear Watching, Too

Taxes—specifically, taxes to compensate for spending cuts Congress is unwilling or unlikely to make—will also come under close scrutiny by policy analysts at the Washington-based watchdog organization. As the Tax Reform Act of 1986 begins to phase in, Tax Foundation policy-watchers say, "Chances are high that it will produce effects that were neither intended nor anticipated when the bill was forged in the legislative process." Because of unplanned economic dislocations and because continuing large deficits cloud the horizon, the Foundation warns, the Federal government can be expected to be continually involved in tax legislation proposals.

The Foundation's program does foresee a greater focus on tax action among the states. "There is a growing shift of responsibility for devising, funding and implementing programs from Washington to the states and localities," the program notes. "Tax Foundation analysts will continue to monitor and report on this change in the balance of intergovernmental relations and the growth of taxes at the state-local levels that it will inevitably entail."

Though there may be "fewer headlines," the Foundation also intends to monitor closely a number of anticipated tax moves during 1987.



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TAX·FEATURES

FY88 Budget Proposes \$40 Billion Cut To Meet G-R-H Target of \$108 Billion

Modified Freeze Could Balance Budget by 1990 Domenici Tells TF Dinner

A "modified freeze" would put the U.S. within \$20 billion of the Gramm-Rudman-Hollings deficit reduction target for fiscal year 1988 and would balance the budget by 1990, Senator Pete V. Domenici told Tax Foundation's Annual Dinner December 3. Delivering a major policy address after receiving the Foundation's Distinguished Public Service Award for 1986, the Senior Senator from New Mexico and Ranking Republican on the Senate Budget Committee told the Dinner attendees that such goals were "clearly achievable" on a current policy basis, "absent a disaster or a catastrophe."

The "modified freeze" proposed by Domenici included recognizing that "American servicemen and American civilian workers ought to get a pay increase every year; and realizing that 'the fight against automatic cost-of-living increases is gone' because 'it's political dynamite,'" Domenici said. "So give everybody their cost-of-living index increase and freeze everything else at today's levels. Don't cut it; just freeze it—a literal freeze."

While working toward the budgetary balance his "modified freeze" promised, Domenici also called for facing up to a number of "serious problems":

- There may be need for \$5 or \$10 billion in additional funds to pay for needed defense outlays. "If they truly need [the additional funds], lay it on the line and say that's an exceptional add-on and it's got to be paid for, even if it means revenues," he said.

- The welfare program currently on the books "does not meet the social problems of today." Among these, the Senator listed the more serious issue of "the single head of household," and the "homeless issue," because "this country is too good and its people are too decent" to let the problem continue unmet.

- Domenici also cited the need for additional research and development to promote competitiveness, health care for the elderly, and what he described as "the incredible infrastructure dilemma of the cities and counties and states."

Some of the funds to pay for these programs, Domenici charged, could be obtained by trading up and trading out funds for programs still on the books

(Continued on page 4)

President Reagan's fiscal 1988 budget promises unprecedented success in reducing the deficit. If the new budget is to be believed, the deficit would be cut in half in two years, from more than \$220 billion in fiscal 1986 to less than \$110 billion in the 1988 fiscal year. The Administration would meet the Gramm-Rudman-Hollings (GRH) deficit target without significant tax increases and with fewer spending cuts than were sought in previous Reagan budgets.

The Political Arithmetic of Deficit Reduction

How does the President promise to cut the deficit without new taxes and with a continued defense buildup? Part of the answer lies in the budget's policy recommendations, part in its economic assumptions. The table on page 2 shows the path taken by the Administration to meet the GRH deficit target. Beginning with fiscal 1987 spending a bit above the trillion dollar mark, the budget estimates that expenditures would rise another \$45 billion if existing policies under "current services" were continued in effect. (The current services budget estimates the amount it would cost to maintain current policy in future years with expected price and workload changes in existing programs but with no spending policy or tax initiatives.) Most of this increase would be concentrated in the two fastest-growing sectors of the budget. Social Security and defense. The first is off limits to budget cutters; the second has strong presidential support for additional funds. Big spending increases also would occur—even if no programs were changed—in other difficult-to-control areas of the budget such as interest costs, Medicare, and other mandatory payments. Only about one-tenth of the current services increases are estimated to occur in the "discretionary," nondefense operations of the Federal government.

On a current services basis, the budget estimates that about \$40 billion will have to be pared from the deficit to meet the GRH target of \$108 billion. A more realistic computation might show the deficit \$60 billion or more above that level.

The proposed fiscal 1988 deficit reduction leans heavily on the revenue side of the budget. While publicly warring against any and all tax increases, the budget expects to generate \$8 billion in additional revenue plus \$3 billion in user fees, and about \$10 billion in income from the sale of government assets.

The budget lists about \$20 billion in proposed

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spending cutbacks, but few of these have much chance of enactment. The biggest savings are sought in Medicare, a program that has had an uncanny ability to grow year after year despite the huge cuts reputedly made in it. And the cuts in farm, low-income, and social programs obviously will encounter strong opposition in Congress.

The Economic Outlook

The fate of deficit reduction depends not only on what Congress does to the budget but also on the performance of the economy. **Rosy scenario—the label for unduly optimistic forecasts that show the budget deficit shrinking as the economy grows—is a bit more modest this time around. Compared to past predictions in the 4 percent range, this year's 3.1 percent forecast for real growth in GNP might well be within reach.** But there are a number of soft spots in the economic outlook that could cause performance to be weaker and the deficit to be correspondingly higher.

Federal revenues are highly sensitive to economic conditions. A small shortfall in growth can translate to a substantial drop in revenue. It is something of an anomaly for the Administration to

(Continued on page 4)

First Boston's Chief Economist Wojnilower Sees Modest Economic Growth in 1987

"Less of the same" was the economic forecast delivered by Albert M. Wojnilower, managing director and chief economist for the First Boston Corporation, in his keynote speech at Tax Foundation's 38th National Conference. He detailed this basic repetition of 1986's economic scenario as:

- 2 ½ percent real growth;
- fewer industrial and regional disparities;
- smaller, but not much smaller, budget and trade deficits; and
- lesser declines in interest rates and the dollar—but still declines, as compared with before.

"If this forecast is wrong," Wojnilower told the 325 business executives, academicians and media representatives present at the conference, "it's going to be wrong not because we have a boom, but because we can't even achieve the 2 ½ percent."

Deficits and Interest Rates

Wojnilower took issue with those who claim that high deficits portend high interest rates. "The large budget

deficits in the economic context in which we have been living," he observed, "have not made interest rates higher than they otherwise would have been. Nor have they made the dollar higher than it would otherwise have been."

In fact, claimed Wojnilower, "despite sharply rising budget deficits, interest rates have collapsed, and in the last year and a half or so, the dollar has also collapsed." In essence, the economy "has not experienced any significant change of pace" for more than two years, he said.

Levelling Off

While the weaker sectors have been "bottoming out," Wojnilower said, "the stronger sectors have been tapering off." He predicted that "the 2 ½ percent type of growth is likely to continue," but forecast a decrease in the "disparities in performance among regions and industries." Consumption "will continue to provide an anchor to the economy," he said.

Along with modest growth in the economy, Wojnilower also predicted modest growth in inflation to "between 3 and 4 percent," assuming not much happens to oil prices. He also saw further declines in interest rates and in the value of the dollar, "but not nearly with the same intensity." He saw "a decline—or maybe more than one—in the discount rate" during 1987.

"We are not on the edge of a boom," he concluded. "We are not on the edge of anything."

The Arithmetic of Proposed Deficit Reduction (\$ bils.)

Fiscal 1987 Outlays	\$1,015.6	
1988 Current Services Increases (net basis)		
National Defense	15.4	
Social Security	11.6	
Medicare	6.6	
Income Security	4.5	
Interest	2.4	
Other Functions	4.4	
1988 Current Services Outlays	\$1,060.5	
1988 Current Service Revenues	910.4	
1988 Current Services Deficit		\$ 150.1
Proposed Revenue Increases and Spending Reductions (net basis)		
Revenue Increases		
User Fees	3.2	
Other Revenue Increases	8.2	
	11.4	
Asset Sales		
Loan Asset Sales	5.5	
Other Asset Sales	5.0	
	10.5	
Spending Reductions		
Health Programs	7.4	
Agricultural Rural	2.5	
Low-Income Programs	3.1	
Education Programs	2.9	
Other Social and Income Programs	2.6	
Other Reductions	2.0	
	20.5	
Total Deficit Reductions		\$ 42.4
Proposed 1988 Budget Deficit		\$ 107.8

Source: Fiscal 1988 Budget of the U.S. and Tax Foundation calculations.

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FEDERAL TAX POLICY MEMO

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JANUARY/FEBRUARY 1987

Congress and the Workplace

By Frank B. McArdle

The second session of the 99th Congress adjourned October 18, 1986. In many ways, it was a remarkable Congress. Tax reform was of course its crowning achievement. But this last session was equally important for other pieces of legislation passed or considered.

How is it that Congress, in passing tax reform, sought to lighten the load of government and of tax considerations on private-sector decisions, and ended up involving itself ever more deeply in the workplace, particularly with respect to retirement income, health insurance, and other voluntary employee benefit matters?

What Does Tax Reform Do to Employee Benefits?

Tax practitioners and employers are struggling to digest this massive bill as quickly as possible but are up to their ears in this task. Not only must they move quickly to comply with the employee benefit provisions, but in addition, the new law will force them to undertake complete reappraisal of their current employee benefit packages.

The effects on benefits come from two directions: from the numerous provisions directly aimed at employee benefits and from the changes in the tax rates. The direct provisions, which took up 114 pages of the Act itself and 179 pages of the Conference Report, are intended to produce more comparable employee benefit coverage of rank-and-file employees and of highly compensated employees. The pension changes would increase the number of workers with a vested interest in their pensions by some 2 million workers in the first year alone. It would increase pension amounts for rank-and-file employees by limiting the coordination with Social Security benefits. And it would mandate broader and more comparable coverage of rank-and-file employees under pension, health, life insurance and other plans. Education assistance and group legal services will lose their tax

exclusion in 1988; employer-provided transportation benefits were allowed to expire.

If rank-and-file workers are the intended beneficiaries, higher-paid employees are the intended losers from the benefits provisions. Certainly the higher paid will enjoy lower tax rates. But they suffer potential losses in benefits. Some examples: restrictions on 401(k) salary reduction contributions; a new limit effective in 1989 of \$200,000 on the amount of compensation that can be taken into account under all qualified plans; a new excess benefit tax of 15 percent on most annual distributions over \$112,500; and sharply reduced maximum benefits paid to early retirees under defined benefit plans.

Changes in the welfare benefit areas, like health and life insurance, also aim for the same effects: an intended broadening of benefits because of tighter nondiscrimination rules that also reduce tax-favored benefits payable to the higher paid. Government staff have argued that reduced tax-favored benefits for the highly paid constitute more comparable coverage of rank and file and highly paid, when you view the benefits in terms of dollars, rather than as a percent of their compensation.

Effect of Tax Rates

Despite its good intentions, some unintended consequences of the new legislation may actually slow the future growth of benefit coverage and even result in less coverage in that sector of the economy—the small employer sector—where benefit coverage is the least available today. A top rate of 28 percent for the owners of a small business and 15 percent rate for 80 percent of taxpayers may make cash more attractive than benefits, which are also more difficult and more costly to administer under the new rules. The desirability of deferring compensation for nonretirement purposes under qualified plans is also called into question, because of new penalties on early withdrawals and the expectation that future tax rates may be higher than the new rates. Finally, because of the new restrictions on the higher paid, many employers will face the option of removing the higher paid from their general qualified benefit plans, which could result in a deterioration in benefits for rank-and-file employees. As more of their compensation is provided through nonqualified plans, the higher compensated may "lose their stake" in the general benefit plan. Obviously, whether nondiscrimination rules cause expanded and more comparable coverage of rank-and-file employees or reduce tax benefits for the highly paid will differ from employer to employer.

Employee benefits will remain an important piece of total compensation, but the changes in their tax effectiveness may

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The following remarks are adapted from an address to the Tax Foundation's 38th National Conference in December 1986. The opinions expressed are those of the author and do not necessarily reflect those of the Tax Foundation.

prompt a reevaluation of overall benefits and a return to the basic purposes employee benefits were intended to fulfill: the nontax purposes of promoting economic security and satisfying human resource needs.

Tax Committees Gain Upper Hand

If the late Senator Jacob Javits (R-NY), the father of ERISA, were still alive, he would tell you that it was the social policy that motivated him and not the tax policy. He and his colleagues approached the subject, as befits the Senate Labor Committee, from the angle of labor law and labor policy. Their goal was to fill a social need—the need for pensions and welfare benefit plans to promote economic security and protection of workers. With that social and labor policy in mind, tax preferences were seen as the instrument to encourage business to assume its share of the national responsibility of providing retirement income. That was the goal; tax preferences were the means of achieving that end. It was that kind of approach that led Senator Javits to start the ball rolling in 1967 that ended in ERISA's passage in 1974.

By the time of ERISA's tenth anniversary the tables had turned. By then, the "tax expenditure concept" was well-established. By that I mean, each dollar in revenue that could have been collected absent a tax preference began to be viewed as a cost to the government, as a government expenditure. In fact, the budget committees of Congress have viewed tax expenditures as entitlements like any other direct spending.

Despite serious flaws in the "tax expenditure" concept, particularly in the calculation and measurement of tax expenditures, the tax expenditure concept influenced congressional thinking.

Despite wild fluctuations in estimation, the size of employee benefit tax expenditures is very large—nearly \$60 billion in annual revenue losses from pension plans plus \$26 billion for health and for other benefits.

Gradually, the tax committees and the tax agencies of the Federal government had the most to say and do about what should be done about retirement income. For some, like Senator Javits, "This is the wrong end of the stick." But like it or not, that is what happened. And so years before the Tax Reform Act of 1986, tax committees had seized the initiative, often with bruised egos and hard feelings among the Labor Committee members who were losing the initiative.

TEFRA Marked the Turning Point

The Tax Equity and Fiscal Responsibility Act of 1982 in many ways marked the turning point. Here base broadening really began. It began because Federal budget deficits were huge and the Congressional Budget Office and others were predicting sharply rising interest rates unless additional revenues were raised. President Reagan stood then as he stands today, adamantly opposed to any tax rate increases. So base broadening was the only real alternative. And Congress took it.

For pensions and employee benefits TEFRA also marked the turning point in these ways:

- 1) Important legislative changes were thrust upon em-

ployers and the workplace without even a chance to influence the process.

- 2) Substantial cuts were made in tax benefits for qualified plans.
- 3) An era of roughly a half century of expansion of social programs and of employee benefits came to a close and retrenchment began.

Employee benefits became viewed by some leading senators and congressmen as "excessive," i.e., they were tax benefits enjoyed primarily by the higher paid, and therefore were an inadequate supplement to Social Security because too few individuals qualified for benefits.

Similar themes inspired the Social Security Amendments of 1983, the Deficit Reduction Act of 1984, and the Retirement Equity Act of 1984. They also spawned legislation to cap health tax benefits and to reform pension vesting integration and portability and coverage rules. And then along came tax reform on the fast track. The private sector looked upon this metamorphosis, or shift in public policy, with a mixture of bewilderment and alarm and betrayal.

As one private-sector speaker said at a conference on ERISA held by the Senate Aging Committee: "There was a time when the Federal government was clearly on the side of providing tax incentives for the development of private retirement programs in ways that advantaged workers in every part of our economy. It's no longer clear that that is the goal of the Federal government. We are hearing more and more about tax expenditures, we are hearing more and more about how this is an unjust way of providing retirement programs, while at the same time, the replacement rates of Social Security have dropped for the average worker. . . ."

So the provision of private-sector benefits, which was once viewed as a social partnership between government and the private sector, had begun to take on more of an adversarial relationship. Certainly there are important exceptions. Certain congressional staff have reached out. But generally an atmosphere of mistrust and suspicion and disrespect has taken hold. And Congress, which was critical of the status quo, was viewed by members of the private sector as being hostile rather than supportive of benefits in the workplace.

Why Did Tax Reform Rule the Workplace?

Treasury made the strongest statement here. Treasury's original tax reform proposal would have abolished many tax incentives for benefits on grounds that, "It is unfair that one taxpayer is excused from paying income tax on the value of a fringe benefit, while another who wants to enjoy the same good or service, but does not receive it as a fringe benefit, must purchase it with after-tax dollars." Benefits were viewed by Treasury as but one example of an overall tax system that is "complex, inequitable, and interferes with economic choices of households and businesses." Even here, however, the critics of inconsistency were themselves not fully consistent. The Treasury proposal made a major exception for retirement programs that are tax favored, saying, in effect, "This is a social purpose usefully and properly fulfilled through the Tax Code."

Echoes of the Treasury statement influenced the general tax reform justification—i.e., less intervention. Dan Rostenkowski, Chairman of the House Ways and Means Committee, argued we must stop using tax incentives to shape retirement policy. And he was by no means alone.

Yet when you look carefully at the final provisions of tax reform, you find very little in the employee benefits provisions that strikes you as government being less interventionist. On the contrary, it imposes the most elaborate and complex specifications that each qualified retirement, health or welfare benefit must comply with since ERISA was passed in 1974. These specifications are so detailed, so complex and so difficult to understand that for many plan sponsors, even for experienced practitioners, full compliance will be difficult, and in some cases well nigh impossible.

And what could not be done on the House or Senate floor did in fact take place behind the closed doors of the conference committee, where an agreement emerged that cut employee benefits by \$44 billion over 5 years—*more in cuts* than either the House or the Senate approved independently. In this case, the tax reform compromise didn't split the difference. Rather, it tended to take the more restrictive of the Senate or House provisions.

Forty-four billion dollars in revenue gains sounds large, and if you measure the revenue effects of the same provisions by using 1986-law tax rates instead of future, lower rates, the revenue gain would be much larger than \$44 billion.

Yet these same decisions about employee benefits reflect the thinking that benefits provided through the workplace are a more effective means of helping individuals than individual efforts by themselves. For example, over half of the benefit cuts come from individual retirement account (IRA) eligibility changes. That decision was revenue motivated—\$24 billion will be saved—but also a policy decision, that employer plans are less discriminatory from a tax benefit standpoint than IRAs, which were far more heavily used by higher-income taxpayers.

Because workplace-provided benefits keep their tax preferences, it is natural to expect more regulation of them. After all, nonintervention in economic decisions was chiefly the argument for *repeal* of tax breaks. Where tax preferences were *retained*, it is logical to expect continuous, even further regulation. What we got was *regulation* with a *vengeance*, a culmination of reforms discussed for years, many for a decade or more.

Here we see a different agenda coming into play, a long-standing agenda of pension and benefit reforms, intersecting or merging with the tax reform agenda. A reasonable argument for doing pension reforms in the tax bill can be made despite the fact that industry begged the Congress to disassociate the two issues of tax reform and pension reform. Interested congressional staff made employee benefits an issue of tax equity, an issue of where the tax benefits flow.

Bottom Line Policy

Practically and realistically, tax reform was the only vehicle likely to carry pension reform. Congress has followed a tendency in recent years to pass megabills dealing with

budget and tax issues. Sponsors of the Retirement Income Policy Act, from which many of the final provisions were drawn, saw this tax reform as the only chance to move the pension bill in 1986. They were able to attach it to the Senate Finance Committee version of H.R. 3838.

What was the policy? Its point of departure was, again, a tax expenditure analysis.

1. Tax benefits should not disproportionately go to higher paid (and hence tighter nondiscrimination rules were legislated).
2. Another policy objective is that programs should supplement Social Security—the purpose of the tax incentive is for that—not for short-term savings plans that are squandered before retirement. The various benefit provisions in tax reform could increase benefit payments at retirement by discouraging lump-sum payments, increasing coverage and benefit receipt, faster five-year vesting, integration, etc.
3. The third policy statement was that tax incentives for benefits should be limited and not unlimited. Within this concept of limits, the goal is to discourage *over*-accumulating as well as *under*accumulating. Provisions reflecting this goal are the 401(k) \$7,000 cap; the excess benefit cap; and the limit on includible compensation.

At the bottom line, Congress was saying to the workplace: "If you want to retain tax preferences for these programs, this is the price you have to pay." For the private sector, the price is administratively cumbersome; compliance is difficult, and costly.

But in the process, the other face of government policy was saying, "We're also going to make you less willing to pay that price." How? Through the lower tax rates of 15% and 28%.

Because of the lower rates, an option for noncompliance with the tough welfare benefit nondiscrimination rules is to remove the higher paid from the plan and have the higher paid pay the tax on the discriminatory (nonqualified) benefits.

Future growth of employee benefits will be far less than previously projected. The Social Security Administration has been projecting that tax-favored benefits would more than double as a percentage of pay between now and the middle of the next century. Actually benefit growth has already slowed down, and the new 15% and 28% rates are like pulling up the emergency brake.

Tax effectiveness can no longer be the chief selling point of a benefit plan. And, *looking ahead*, if you foresee higher tax rates, as many of us do, the wisdom of deferring compensation is called into question.

With tax effectiveness no longer the *chief selling point*, the decision to offer employee benefits will turn on different considerations. We will return to the original purposes of benefits: providing economic security and human resource needs.

So in this sense, the Federal government, through the lower tax rates, is after all intervening less in the *decision* to offer benefits. But *once* the decision to offer them is made, then the Federal intervention is direct and detailed to make sure the social policy purposes are being achieved. And this latter

type of Federal intervention in the workplace is likely to grow, rather than diminish in the future.

Other Mandates in the Workplace

Take a look at some other recent legislation:

- 1) Abolishing mandatory retirement.
- 2) Mandating that employers continue providing pension accruals and contributions for workers beyond age 65.
- 3) Proposing that employers contribute to state-wide risk pools to provide health coverage to the uninsured.
- 4) Proposing a mandate to provide unpaid parental leave.

The overall message is: Government wants to pay less for tax expenditures and wants to buy more for its money. Buying more for its money means thrusting greater social responsibility on employers. As Senator Javits would have said, "Business is going to be asked to shoulder its share of the social responsibility."

In the case of employer-provided retiree health benefits, we have seen Congress intervene to pass two different pieces of legislation directly aimed at a single company—LTV—and any others that may want to follow in the tracks of LTV Corporation.

During the 99th Congress, at least four bills passed that will affect employer-provided health care benefits; another seven were approved by committees of Congress; and another twenty did not make it out of committee. In all, some 30 odd bills in the 99th Congress.

The New Congress Will Continue Intervention

We have every indication that the 100th Congress, again limited by huge Federal deficits, will seek to fulfill social purposes in ways that don't carry a direct Federal price tag.

We note, for example, the statement Senator Edward M. Kennedy made last fall on his decision to assume the chairmanship of the Senate Labor and Human Resources Committee. He said he welcomed the opportunity to participate in "creating a new agenda for social progress in America." He went on to explain that he was "convinced that new approaches can work without increased spending. In a sense, the challenge on social issues in the next Congress," he continued, "will be the same far-reaching challenge met and mastered by the past Congress on *tax reform*—to develop *revenue-neutral* approaches that advance the great economic and social goals of our nation."

Now, one way of providing his goal of greater health coverage without more Federal spending is to mandate that employers provide more through the workplace. It therefore comes as no surprise to learn that Senator Kennedy intends to reintroduce the Access to Health Care Act that would have required employers to extend health insurance coverage to laid-off workers for four months and forced states to set up payment systems for uncompensated health care and insurance pools for individuals at high risk. Senator Kennedy's staff have now reportedly been saying that the new legislation may require that all U.S. employers provide at least a minimum level of health insurance coverage to all workers. That could be done by making health benefits part of the minimum wage.

Senator Kennedy is by no means alone in viewing mandating as a way of getting more out of the workplace. Mandating benefits through the workplace is also not something unique to the Federal government. Members of Congress have watched the states impose more and more rules. More than half of the states, for example, mandate some form of specific health provision by employers, although the reach of these state mandates does not extend to the growing number of large employers who self-fund their health insurance plans.

Not only is there precedent for Federal mandates coming from the states, but when Health and Human Services Secretary Otis Bowen released on November 20 some recommendations to improve catastrophic protection for the general population, one of his recommendations was that states mandate the offer of catastrophic protection in employee-related health insurance. In effect, the Federal government would be urging and relying on state mandates.

Tension Between Congress and the Private Sector

We have talked about "Congress and the Workplace" and at times the adversarial stance that people in the private sector perceive about the way Congress acts on benefit issues. In the long run, I don't believe that attitude really can endure, because it is antithetical to a representative political system such as ours.

It happens in the short run, in part, because these benefit issues are so technical and so complex that individual members of Congress don't understand them and don't in fact decide them. More than any other issue, benefit decisions are delegated to staff. That delegation is unwittingly facilitated by the private sector, because often the business leaders do not escalate these issues to the level that *demands* a member of Congress' attention. For example, during tax reform, business had so many other overriding tax issues, that most had "bigger fish to fry." Few wanted to expend all their political capital on an issue that does not directly affect the corporate bottom line.

The trend that we foresee of greater congressional intervention and mandating of social responsibility is going to affect a firm's bottom line, its profitability. For example, if a tax were levied upon firms to finance risk pools for the uninsured, in effect, business would be taxed to provide benefits to nonemployees. This may cause corporate leadership to escalate the priority of some of the benefit issues, particularly if the Tax Code remains stable for awhile and competing tax issues do not come to the fore. But if business does not make benefits a priority, Congress will make the decisions for them.

Finally, the private sector can influence Congress through its own good example. Often, Congress will take a practice developed in the private sector but practiced by a minority of firms and make that the norm. For example, in the employee benefits area, one could argue that congressional mandating of faster vesting and revised integration rules did not come completely out of nowhere. By shifting to defined contribution plans increasingly, the American workplace implicitly recognized the need for faster vesting. If the private sector cannot stop congressional intervention, it can nonetheless do much more to shape its long-term course.

Tax Bill's Effects on Economy/States Weighed at Conf.

No detailed and definitive assessment of the economic fallout of the Tax Reform Act of 1986 (TRA-86) is possible, Norman B. Ture, president of IRET and former Undersecretary of the Treasury for Tax and Economic Affairs, observed to the morning session of Tax Foundation's 38th National Conference. The Bill is so large and varied, he said, and so is the economy of the United States, that precise analysis is impossible.

A Major Revision

Calling TRA-86 "surely among the very biggest tax events in our nation's fiscal history," Ture faulted the policy-makers who developed the legislation for focusing little attention on how the Act would affect the U.S. economy. The reason, he contended, was that "the process was driven by an initial decision about some specified tax changes, principally rate reductions, constrained by the dicta of revenue neutrality and no new revenue sources, fueled by efforts to rationalize these changes in terms of policy objectives—simplicity, equity, and economic neutrality—the substantive content of which was never spelled out."

- *Simplification.* "In a nutshell, the relevant measure of tax simplification is the extent to which it results in shrinking the Internal Revenue Service," Ture said, contending that, under TRA-86, "the tax law has been made substantially more complex."

- *Equity.* "It is difficult to discern in TRA-86 anything that represents a significant equity advance," he maintained. "There are, on the contrary, numerous changes in the Act that make the income tax more unfair."

- *Economic Neutrality.* Achieving neutrality in tax policy, Ture explained, "requires first identifying the relative price effects of the tax or of specific tax provisions; you're not likely to hit a target you don't see. No such effort was apparent as TRA-86 went from drawing board to final enactment."

Ture predicted:

- a gradual slowdown in addition to the stocks of capital in the industrial sectors, possibly accompanied by relocation of expansion from domestic to foreign sites;

(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation

"A Backdoor Tax Hike"

It is a commonplace of constitutional law that no U.S. Congress can bind another. Before the 100th Congress even left the starting blocks, this became apparent once more, as part of the congressional leadership floated the idea of reneging on the rate cuts written into the Tax Reform Act of 1986 (TRA-86) by the 99th Congress.

Under TRA-86 the top individual rate is scheduled to drop to 38.5 percent in 1987 and 28 percent in 1988. Congress is manifestly incapable of reaching the 1988 Gramm-Rudman-Hollings deficit reduction target of \$108 billion. So part of the leadership wants to lock in the 1987 top rate "temporarily" to reduce the deficit.

Freezing the top rate at 1987 levels, we are told, affects only "the wealthiest people of our country." Apparently, \$54,000 of taxable income now ranks an unmarried American worker among the "wealthiest." In fact, if the 35% rate were kept, too, this group would include those with incomes as low as \$27,000. To make a real dent in the deficit, Congress would have to extend both the 38.5% and the 35% rates. There is also a lot of vagueness about how long this "moratorium" will last.

There are many sound reasons for opposing this fiscal shell game, no matter how many taxpayers at whatever income levels are affected:

- TRA-86 cancelled an enormous number of tax preferences in the name of simplification and in exchange for rate reductions. Freezing the rates at 1987 levels would be a *de facto* tax hike that betrays that compact.

- Withholding the rate cuts is the crassest kind of bait and switch tactic. It would seriously erode what little credibility the U.S. Congress has.

- TRA-86 survived the legislative grist mill largely because lower rates were perceived as compensating for the loss of tax preferences, making the bill revenue neutral. Locking in the '87 rates will destroy any pretensions TRA-86 may have to neutrality.

- Tax uncertainty has been a millstone around the neck of the U.S. economy for a decade. Such a quick about-face on a bill that was supposed to see us at least through the end of this decade will only aggravate uncertainty. If the moratorium is in fact a moratorium, how long will it last? What will be the final rate? Who will believe Congress, no matter what answer it gives?

The U.S. Congress has no monopoly on bad ideas. However, proposing to hold back the rate cuts of what Congress has been vaunting as the greatest piece of tax reform legislation of this generation almost before the ink was dry on the President's signature on TRA-86 has to rank as a world-class blunder.

POLICE PROTECTION?



(1988 BUDGET, from page 2)

raise its revenue estimates at the same time that it has lowered its forecast for economic growth.

If the budget's long-range forecast is to be believed, the nation will go through a full decade without a recession. Indeed, the growth assumed for the end of the 1980s and beyond is far above recent experience.

Interest rates are another vulnerable piece of the economic puzzle. The White House is banking on a continuing decline in both short- and long-term rates. In fact, it anticipates that "real" interest rates (the difference between inflation and nominal interest rates) will drop from 7 percent in 1985 to only 3 percent in 1988. With the Treasury heavily dependent on Japanese and other foreign investors to market its obligations, a lot of things can go awry and spur a renewed spiral in interest rates.

Other Revenue Questions

Higher deficits also can be caused by revenue shortfalls that are due to estimation errors rather than to economic conditions. The new budget is especially prone to these errors because tax reform has made revenue estimates much more uncertain than is usually the case.

The table presented below displays the long-term trend in revenues. Note that the shift in the income tax burden from individuals to corporations will lead to a projected rise in corporate income taxes from 8.2 percent of total receipts in 1986 to an estimated 12.8 percent in fiscal 1988. This is an exceptionally large swing in a short period of time.

General revenues now cover only about 80 percent of general outlays. This percentage may well decline further as social insurance funds become even more prominent in the total Federal budget. The result could be an even tighter squeeze on government operations than indicated by the overall figures.

(DOMENICI, from page 1)

that he characterized as old, outmoded, irrelevant and lacking in cost-benefits. While not ruling out the need for additional money on the revenue side, Dominici said, "It's clearly achievable with some sort of user fees and the like."

Calling the Gramm-Rudman-Hollings deficit reduction from fiscal 1986-1987 "the most significant deficit reduction in the history of the Republic any way you look at it," Dominici told the Foundation's Trustees and other leading business executives at the Dinner, **"I urge that you join with anyone who will make it tough on Congress to wipe out Gramm-Rudman-Hollings . . . join with those who would put the teeth back in."**

Foundation Chairman Hans W. Wanders of The Wachovia Corporation, who presented the Distinguished Public Service Award to the Senator, pledged, "I can promise you that the resources of the Tax Foundation will be available to keep the spotlight on the real issues, to make sure that the numbers used in the debate are accurate and honest, and in cutting through the linguistic density that public officials love to use to obscure things they'd rather not have see the light of day."

In the 20 months until the 1988 fiscal year goes into the history books, a lot of things can go wrong to unravel the Administration's budgetary optimism. The economy might falter, interest rates might start to climb, Congress might legislate spending increases rather than cutbacks, revenue might come in lower than expected. **Not everything that can go wrong has to for the deficit to soar high above the GRH target level. A fair reading of the 1988 budget leads to the following warning: The battle of the deficit is not over. The outlook is more favorable than it was last year when the deficit exceeded \$220 billion. But it wasn't hard to get to \$200 billion a year deficits; it won't be hard to repeat the same mistakes.**

('86 TAX BILL, from page 3)

- a shift from production for export to production for the domestic market; and
- erosion of the tax-exempt municipal bond market and real estate development.

Keep Rate Cuts on Track

"What saves [TRA-86] from being an economic catastrophe," Ture concluded, "is its rate reductions. He warned that any move to extend either 1986 or 1987 rates, rather than move the rate-cut timetable forward on schedule "would impose a serious threat to the economy."

Impact on the States

Anticipated effects of TRA-86 on state/local governments came next on the conference agenda, covered by Professor James A. Papke of Purdue University. He anticipated that "1987 will probably go down as a record year in terms of action at the subnational level."

He pointed out that, despite reports that state/local governments are "running a small surplus," conditions vary "substantially" from state to state, with oil patch states recording negative balances and smokestack and Eastern states "enjoying substantial positive balances."

"There will be no rush to adjust state-local sales taxes," Papke said, "although the repeal of the deductibility of this levy may lead states heavily dependent on sales taxes "to look carefully at possible increases."

"The most significant effect" on state and local governments "will be to increase competition among the states, primarily for businesses, but also indirectly for individuals as well. . . . There will be increasing emphasis on creating distortions in tax structures in order to attract business."

Frederic W. Hickman, partner in the Chicago law firm of Hopkins and Sutter, also participated in the morning session on "The Tax Reform Act of 1986." Most of his presentation is reproduced in the November/December 1986 issue of *Federal Tax Policy Memo*. Copies are available from the Tax Foundation.

The afternoon session addressed the issue of "Congress and the Workplace." Speakers were Frank B. McArdle, director, Education and Communication of the Employee Benefit Research Institute, whose presentation appears as this month's *Federal Tax Policy Memo* and A.L. Singleton, minority chief of staff, Ways and Means Committee, U.S. House of Representatives.

Budget Receipts

	Amount (in billions of dollars)				% Budget Receipts			
	1968	1978	1986	1988*	1968	1978	1986	1988*
Individual Income Taxes . . .	\$69	\$181	\$349	\$393	44.9%	45.3%	45.4%	42.9%
Corporate Income Taxes . . .	29	60	63	117	18.7	15.0	8.2	12.8
Social Insurance Taxes	34	121	284	333	22.2	30.3	36.4	36.4
Excise Taxes	14	18	33	33	9.2	4.6	4.3	3.6

Source: Budget of the U.S. Government, FY1988 and earlier years.